

How is the current Sovereign Risk Crisis in Europe impacting credit?

Fixed Interest and Credit Research

May 2010

Q&A with the CFSGAM Fixed Interest and Credit team

Question: In light of recent developments in Europe and rising sovereign risk, how do you perceive the sovereign debt problems impacting credit?

Answer: We believe that it's important to understand the difference between sovereign debt risk and corporate credit risk. The current market volatility reflects concerns that some European governments (particularly Portugal, Italy, Ireland, Greece and Spain) might default, due to their high public debt and budget deficits. However, even if one of these countries were to default, that does not mean that a company from that country would default. From a default risk perspective, the sovereign debt crisis in Europe has no direct implications for a pure credit fund such as the Wholesale Global Credit Income Fund (the Fund). However, there are indirect linkages and the market's concerns about sovereign risk deterioration are flowing into sentiment in global credit markets.

Credit risk for corporations is indirectly linked to the level of risk in its country of domicile through economic policies. For example, the imposition of additional taxes may affect a company's financial position, while lower government spending could lead to reduced consumer demand. But this relationship is not linear. In fact, it's worth keeping in mind that the Global Financial Crisis (GFC) triggered a deep deleveraging cycle in the private sector, with this balance sheet repair significantly improving the fundamentals for credit. In order to let the private sector deleverage, governments facilitated this by absorbing the risk and expanding their balance sheets. Hence the significantly improved credit matrix for some segments of the corporate sector left their debt in a more favourable situation than their sovereign's.

A good example of this is Spanish telecommunications company Telefonica. Telefonica's solid credit and liquidity profile and international diversification may allow the firm to continue to raise funds with relative ease from capital markets even if Spain's sovereign rating declines.

Another indirect linkage is through the belief that fiscal austerity programs required to address the sovereign risk situation will result in much slower economic growth in Europe and the rest of the world. Slower growth scenarios tend to see less risk appetite, with equity markets weakening and credit spreads widening across the board, not just for companies that operate in Europe. To a large degree, this is what now seems to be driving the weakness in global credit markets.

Question: How much exposure does the Fund have to European credit, particularly to Portugal, Italy, Ireland, Greece and Spain? What is your view on these holdings?

Answer: The Fund has a total of 13% exposure to eurozone corporate issuers and 8% exposure to UK corporates. The Fund has no exposure to any Greek or Portuguese credits, therefore the repricing of these credits has had no direct impact on performance. Absolute percentage holdings of other countries include a 1% exposure to Spain, 0.29% exposure to Ireland and 0.89% exposure to Italy. Individual exposures include telecom companies such as Telecom Italia and Spanish Telefonica, and utilities such as Italian Enel and Spanish Iberdrola. All of these issuers are investment grade global businesses not totally reliant on their domestic economies, with spreads that we find attractive relative to their credit metrics. Our exposures are based on the credit quality of companies and their diversification benefits for the portfolio, with risks under constant monitoring by our credit research team.

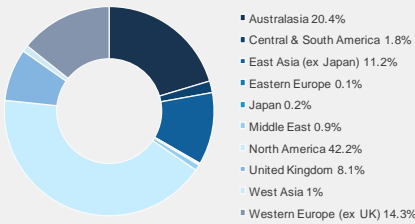
Question: Is there any exposure to European high yield issuers in the Fund?

Answer: The high yield portion of the Fund's exposure (currently 23%) is primarily to US high yield issuers. Less than 1% is in European high yield securities.

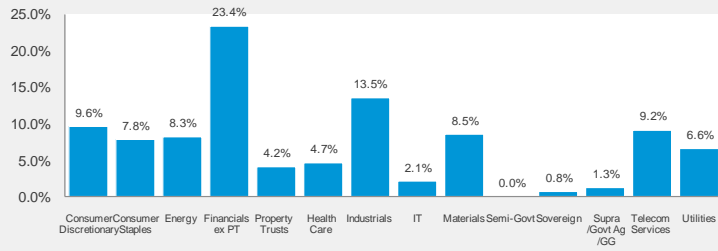
Question: How is the Fund positioned? What is the current running yield of the Fund?

Answer: The Fund is well diversified across regions, quality segments and industries. We maintain only small exposures to individual issuers to ensure that even if a default occurs, it should not have a large and unexpected impact on the Fund. The running yield of the Fund was 9.4% as at 24 May 2010, made up approximately of 4.6% underlying bank bill yield and 4.8% of credit spread.

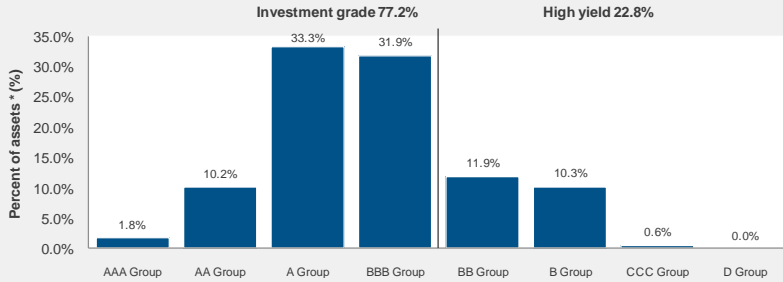
Regional exposure breakdown



Sector exposure breakdown



Quality exposure breakdown



Excluding cash, FX, futures, interest rate and cross currency swaps
Source: Colonial First State Global Asset Management

As at 24 May 2010	WGCD
FUM (AUDm)	3,919
Number of issuers	515
Number of industries	66
Number of countries	38
Modified duration (years)	0.27
Yield to maturity (%)	9.16
Spread over benchmark (%)	4.51
Credit spread duration (years)	4.78
Largest single exposure (%)	1.14
Average exposure (%)	0.19

Question: What, therefore, is the outlook for the Fund? Where do you currently see opportunities in credit?

Answer: Selective quality segments and names in credit markets remain attractive from a risk return perspective. As such, we continue to take advantage of opportunities to buy well paying longer dated securities. While sovereign concerns are creating volatility, it also creates opportunities to actively manage portfolios across issuers, currencies and specific stocks.

We continue to build diversified portfolios using a bottom-up approach, with a portfolio overlay to ensure regional and industry exposures are appropriate. We concentrate on gaining the most efficient exposure to borrowers and are active buyers of multi-currency bonds and users of CDS. Market dislocation remains a considerable source of value add as bonds from the same issuer can trade far cheaper in some currencies than others. We look to continue to accumulate longer dated positions where credit fundamentals are supportive and credit curves remain steep. We continue to avoid perpetual non cumulative securities given the equity like characteristics and at times very large volatility.

Question: How would another wave of credit spread widening impact the Fund? How would returns in the Fund be affected?

Answer: Further spread widening is a possibility. Fiscal consolidation in most developed economies is the only way back to a balanced budget, which could lead to slow growth, or even a contraction in vulnerable economies. This could create a less favourable credit environment and market belief in this scenario seems to be the reason that credit spreads are currently widening. This in turn has had a negative mark to market impact on performance. (When credit spreads widen, yields on corporate bonds rise/prices fall, hence mark to market valuations are negatively impacted.)

Although we don't make forecasts about potential credit gains or losses, the resilience of the Fund was tested during the GFC. The Fund did not need to make stressed sales as our holdings are carefully researched, analysed and selected issue by issue. We not only rode out the volatility even as mark to market (unrealised losses) impacted performance, but positioned the Fund to benefit from the wider spreads that were available. The very strong returns of the past 12-15 months have been a reflection of that.

The primary long term risk to the performance of the Fund has always been, and continues to be, credit defaults. The Fund experienced just 0.8% of realised losses due to defaults in the last two years, which were the worst years for credit in many decades. With much of the mark to market losses (representing daily volatility in price valuations) of 2008 now largely recovered, our strong credit research and security selection approach is expected to continue its strong track record of a lower than market default rate going forward.

The Fund is well diversified and changes on individual issuer, or even regional level, should not have a large and unexpected impact on the Fund. We vigilantly monitor all our exposures, including Europe, on a daily basis to make sure risks are compensated and default risk is minimised. We see spread widening as a potential buying opportunity as it means we can lock in higher returns. Of course this only occurs where spreads clearly compensate for the unit of risk taken. Higher spreads locked in during the crisis have certainly enhanced returns in the past year or so.

The Fund is currently earning close to 480bps spread over its cash benchmark. As a rough guide, with the credit duration of the Fund at approximately 4, a general widening in credit spreads of 100 basis points over a year would see the fund lose approximately 4% in unrealised losses. With the current spread at approximately 480 basis points, this would result in a theoretical 12 month return (all other things being equal) of approximately bank bills plus 80 basis points. Importantly, as our holdings gradually pay interest and mature, we can invest these cash flows into higher yielding assets and lift the longer term return expectation for the Fund.

Question: What are the implications for other diversified portfolios, such as the Diversified Fixed Interest Fund (DFI)?

Answer: Among DFI's investments are holdings in global credit and international high yield. However it also invests in Australian government and semi-government bonds and in the Global Bond Fund, which have performed strongly during the recent weakness in corporate bond markets. The DFI's sector allocation is actively managed to hold the appropriate mix of government bonds and credit, taking into account the attractiveness of spreads and the risk/return of the various market segments.

Question: What are trading conditions like? Is liquidity drying up?

Answer: Liquidity has certainly been tighter in recent weeks as a result of the uncertainty in Europe. The EU and IMF put together an unprecedented European stabilisation package for EUR 750bn on 10th May to prevent another liquidity crisis, and reduced the risk of contagion. The market responded positively and liquidity conditions have since eased, although liquidity is still tighter than at the beginning of the year.

Question: How do you see the latest developments in Europe? Will Greece default?

Answer: Our initial reaction to the EUR 750bn stabilisation package announced over the weekend of 9th May was positive for the peripheral European economies. It demonstrated a clear commitment by the European authorities to the euro and signals greater efforts will be made in the future to develop the eurozone from a currency bloc into a fully fledged federal system. Recent comments by various governments and the ECB also signal that the EU does not want to see any of its members default.

Our view is that Greece will do its best to implement the austerity measures set by the EU and IMF in order to continue receiving funds (please see our research note Greece – May 2010 for details). Nevertheless, even if Greece does default, it would not mean that all Greek corporations would default too. Banking sector losses would be certainly a concern, but the EU, IMF and ECB are well aware of these risks and are working together to avoid negative outcomes.

Question: Many investors are nervous that the European sovereign risk crisis may spread and turn into a global liquidity and then a credit crisis, as we have seen during the GFC. Do you think it's another credit crisis in the making?

Answer: The large European stabilisation package calmed the markets and seems to have prevented another liquidity crisis. However, solvency issues and unsustainable public finances remain a problem in Europe and elsewhere in the developed world. The transfer of debt and risk from the private to the public sector should have been intended only to 'buy time'. In due course, public debt levels have to be brought under control and the overall leverage of the world economy reduced, even at the expense of lower growth for the next few years. As long as governments commit to fiscal consolidation to bring their budget into balance, developed world economies are flexible and credible enough for the markets to keep lending to them. But if fiscal consolidation and deleveraging gets sidetracked, in the hope that developed economies can 'borrow to grow' their way out of current imbalances, returning to sustainable growth may be threatened.

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